Directorate of
Intelligence

Secret

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International Economic & Energy Weekly [redacted]

25X1

18 February 1983

Secret

DI IEEW 83-007
18 February 1983

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International Economic & Energy Weekly [redacted]

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18 February 1983

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Synopsis

Perspective—*Economic Recovery and World Trade* [redacted]
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World trade has stagnated for a second consecutive year, and prospects for a strong upturn appear bleak. If, as we except, recovery in the industrial West is weak, calls for more protectionism probably will increase [redacted] 25X1

Canada: Protectionist Trends [redacted]
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Ottawa is responding to heavy pressure to protect domestic industry by imposing a broad variety of nontarriff barriers. Declining domestic demand, coupled with rising import penetration in the automobile, textile, and footwear industries, have caused major cutbacks in Canadian production and have led to restraints on imports of these goods. Canada's protectionist policies are unlikely to change greatly with either of the two major parties in office. [redacted]
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International Finance: The IMF Quota Issue [redacted]
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Pressures to borrow from the IMF are now more severe because of the wrenching structural adjustments to global recession that nearly every country is experiencing. Under the eighth quota review, the IMF last week agreed to boost members' subscriptions from about $65 billion to approximately $100 billion on the assumption that increased resources will be necessary to meet members' needs for balance-of-payments assistance through most of the 1980s. [redacted]
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Coal Synfuels: Diminished Expectations [redacted]
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Declining oil prices, escalating capital costs, and reduced government funding have combined to cause massive cancellations and delays in coal-synfuel projects around the world. As a result, coal synfuels are unlikely to make much of a contribution towards reducing the Free World's dependence on Middle East oil or Western Europe's and Japan's rising reliance on imported natural gas over the next two decades. [redacted] 25X1

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International Economic & Energy Weekly (U)

18 February 1983

Perspective

Economic Recovery and World Trade

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World trade has stagnated for a second consecutive year, and prospects for a strong upturn appear bleak. The prolonged economic recession in the West has been the driving factor but other trade contracting forces have been set in motion. Protectionist pressures are mounting worldwide, financially strapped LDCs are cutting back imports, and the oil producers are constraining the growth of their economies as their current account surpluses disappear. Although we do not foresee a collapse of trade similar to that of the early 1930s, we believe that a return to the heady days of the 1950s to mid-1970s is unlikely in the next few years.

Throughout the postwar period growth and trade were interlinked—continued economic growth stimulated a further expansion in trade, which contributed to more rapid economic growth. In 1948-73 world production rose at an annual rate of 5 percent while trade grew at a 7-percent rate. Under the auspices of the GATT, trade barriers—especially tariffs, the most obvious form of protectionism—were lowered and made less discriminatory.

However, both economic growth and world trade faltered in the mid-1970s and have slowed drastically since 1980. During 1980-82, OECD real output has risen only 2 percent; LDC real output has increased at a 1-percent annual rate compared with a 5-percent pace in the last half of the 1970s. Reflecting the slowdown in growth, world exports, as reported by the OECD, declined slightly in 1981 and fell by an estimated 3 percent last year.

The near-term outlook for growth and trade is not promising. Most observers believe OECD growth will average just over 2 percent through midyear 1984 with accompanying increases in unemployment and mounting protectionist pressures. Governments increasingly view imports as a threat to domestic jobs and are resorting to quotas, voluntary restraint agreements, and local content rules to stem the flow of foreign goods. The failure of last fall's GATT Ministerial to make a strong commitment to stop the slide into protectionism is symptomatic of the changed circumstances.

Slow OECD growth will also translate into little or no increase in LDC export earnings, forcing further slashes in LDC imports. The slump in export sales could precipitate moves on the part of the developing world to try to conserve badly needed foreign exchange reserves. In addition, LDCs may increasingly seek barter trade arrangements and focus on expanding intraregional trade. A substantial increase in bilateralism and regionalism could seriously threaten multisided free trade.

In our judgment, the key to a pickup in world trade is a strong economic recovery in the industrial West. Protectionist pressures would ease and intra-OECD trade would expand. At the same time, the OECD recovery would boost LDC export earnings and would signal to the banking community that LDCs are better positioned to handle their debt. Once activity picks up and non-OECD countries have reduced their external deficits to sustainable levels, OECD export opportunities would expand and further stimulate growth in world trade.

If, as we expect, recovery in the industrial West is weak, calls for more protectionism probably will increase. The structural changes in the industrial countries, particularly the decline in heavy industry, will foment protectionist sentiment which, in turn, could further impede the recovery of world trade. At the same time, the financial problems facing the LDCs probably will persist, prompting LDC governments to continue restraining the inflow of foreign-made goods.

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Briefs

Energy

Demands for Oil Price Cut

An announcement by the British National Oil Company that it will propose a crude oil pricing arrangement on Friday could lead to a price cut that would touch off a reduction worldwide. Libya is already calling for a special OPEC meeting to consider an oil price reduction as buyers demand an adjustment. Shell Oil Company has stopped buying at official prices, and a number of Japanese companies have refused shipments from the Persian Gulf. Libyan and Nigerian exports are reported down about 500,000 barrels a day in recent weeks, [redacted] 25X1

[redacted] expect BNOC to announce a $2 to $3 per barrel reduction in official North Sea prices. Indications of a cut by the British along with recent threats by Saudi Arabia and its Arab neighbors to lower prices have encouraged buyer resistance, increasing willingness in OPEC to accept a price reduction on Saudi terms. Arab producers in the Persian Gulf are seeking a new pricing formula based on a benchmark price of about $30 per barrel, $4 below the current price. Libya's willingness to adjust prices is a major breakthrough. Mexico wants to delay its decision until after other producers make the first cut, but it would be quick to follow to protect its share of the market. [redacted] 25X1 25X1 25X1

Venezuelan Oil Spending Trimmed

Recently announced spending cuts in the petroleum sector will have little immediate impact on the country's oil industry but could affect plans to raise crude oil productive capacity to 2.6 million b/d by mid-decade. The US Embassy reports that investment by the national oil company, PDVSA, is forecast to be about $3.4 billion this year—a cut of about $1.3 billion—and spending over the next five years is projected at $21 billion, a 40-percent drop from earlier plans. [redacted] 25X1

Development in the Orinoco heavy oil region will continue, however, and should provide enough new production in coming years to offset declines in many of Venezuela's older oilfields. Expansion of total productive capacity by 200,000 b/d in mid-decade, as planned by Caracas, however, is now unlikely. The spending cuts will more immediately affect US firms, which provide Venezuela with about 60 to 75 percent its oil sector's annual imports. A contract held by Lummas engineering, an American firm, for the $4 billion Cerro Negro heavy oil project has effectively been canceled. Foreign purchases of drilling pipe this year are reported to have been cut in half and the contracts that have been awarded have gone to Japanese suppliers submitting exceptionally low bids. [redacted] 25X1

Canadian Nuclear Power and Electricity Exports

A recent Canadian Government study indicates that direct government intervention may be necessary to assure the viability of the Canadian nuclear industry. To avoid direct government subsidies, the Canadians are planning to push for increased electricity exports from nuclear power plants to the United States. Early this month, the Point Lepreau Nuclear Power Plant—the first plant with a portion of capacity specifically designated for export—began exporting electricity to the United States. A second nuclear plant—wholly committed to electricity exports—has been proposed for Point Lepreau, and additional proposals for nuclear power plants devoted to the export of electricity are expected. In 1981 Canada exported nearly 34 billion kwh of electricity to the United States—representing the energy equivalent of 170,000 b/d of oil. Nearly 90 percent of this electricity went to the industrial Northeast and the far West, two areas of the United States where numerous nuclear power plant construction projects have been canceled. 25X1

Weak Response to Indian Oil Exploration Offer

India's latest offer of petroleum exploration and production sharing rights has apparently generated almost no interest from foreign companies, partly because of the world oil glut. While foreign suppliers are offering drilling rigs and platforms at cheaper prices and more favorable credit terms than in the past, Indian petroleum companies cannot afford to expand their own efforts to investigate the less promising areas that were offered to foreign companies. New Delhi will benefit from the slight reduction in development costs, but long-term hopes of reducing a crippling oil import bill by increasing domestic supplies have been dimmed. 25X1

International Trade, Technology, and Finance

Chinese-Canadian Textile Talks

According to the US Embassy in Beijing, Chinese and Canadian trade officials earlier this month failed to agree on a new level for Chinese textile exports to Canada. Canada is threatening to abrogate its textile agreement with China and impose unilateral controls if lower import levels cannot be negotiated. Beijing threatened to reduce purchases of Canadian grain if Ottawa took unilateral measures. The Chinese made similar threats last month against US grain firms because of US textile quotas. 25X1

The threats to boycott US and Canadian grain appear to be negotiating tactics. Although the Chinese are increasing purchases of Argentine and French grain, the United States and Canada normally supply nearly 80 percent of China's imported grain, and China is unlikely to drastically cut purchases from both sources. 25X1

NTT Support for Japanese Computer Firms

Nippon Telegraph and Telephone Corporation (NTT) plans to invest over $1 billion for computer development during the 1980s, according to press reports. Fujitsu, NEC, and Hitachi reportedly have been selected to develop the computers. NTT's planned investment apparently will exceed direct MITI aid to the Japanese computer industry and may allow the firms to shield development of key technologies from competitors such as IBM Japan that are seeking to become involved in MITI programs. [redacted] 25X1

Ostensibly, NTT plans to develop two major series of mainframe general purpose computers to be introduced in 1987 and 1990 for use by NTT. According to press reports, the later series will incorporate revolutionary changes in computer technology using ultra-high-speed components and a radically new and powerful design. We believe the NTT program will have significant commercial implications for Japan's computer industry. We expect Fujitsu, NEC, and Hitachi to develop and produce their own commercial versions of NTT's planned new computer systems, although NTT will bear most of the development costs. [redacted] 25X1

Increased LDC Protectionism in Shipping Trades

Libya's General National Maritime Company reportedly has agreed to a joint service with three British shipping lines. A centralized booking agency controlled by the Libyan company will allocate cargo among the lines, reserving 50 percent for Libyan ships and eliminating opportunities for ships of third nations. Libya apparently intends to extend this program to its trade with other important trading partners. [redacted] 25X1

The Libyan action follows similar moves by Brazil and Argentina, which first concluded protectionist liner agreements several years ago. Venezuela, the Philippines, and other LDCs are preparing protectionist measures of their own. Most LDCs are seeking to legitimize bilateral cargo sharing in the liner trades, drastically reduce or eliminate the use of flags of convenience, and impose mandatory cargo sharing for bulk cargoes from developing countries. [redacted] 25X1

The Libyan-British arrangement and similar moves by other countries almost certainly will result in higher freight rates for shippers and seriously reduce cargoes for third nation ships. Western shipowners' acceptance of such terms, moreover, will make it more difficult for their governments to argue against such protectionist measures. [redacted] 25X1

National Developments

Developed Countries

Tokyo Proposes New Depressed Industries Law

MITI is seeking to broaden a law, due to expire in June, that authorizes the formation of cartels to ensure orderly reductions of capacity in industries faced with long-term declines in demand. The new legislation would also provide financial and tax incentives to help restore international competitiveness. If the

Cabinet and the Diet agree, firms in the seven designated industries—electric furnace steel, aluminum refining, chemical fibers, petrochemicals, chemical fertilizers, cardboard, and ferroalloys—would be eligible for:

- Subsidies to fund research and development.
- Special first-year depreciation allowances on new capital investments.
- A 10-year, rather than the current five-year, carryover of capital losses incurred in the disposal of excess production capacity.
- Japan Development Bank loans to finance capital investments involving new technology and to pay retirement bonuses to employees who retire early as part of a capacity reduction plan. [redacted] 25X1

In an attempt to obtain Japan Fair Trade Commission (JFTC) approval of the draft legislation, MITI has dropped several controversial provisions that had also raised concern in Washington. The new law would be valid for five rather than the 10 years originally proposed. In addition, mergers, sharing of production facilities, and joint sales networks would remain subject to JFTC review, and MITI would have to consult with the JFTC on the antitrust implications of "structural improvement plans" before approving them. Despite these concessions, the Japanese press reports there are still differences between MITI and the JFTC on the law. The JFTC is said to oppose a provision that it make public its criteria for approving or rejecting mergers. JFTC officials believe they would then have difficulty rejecting any merger, no matter how anticompetitive, so long as it did not violate the letter of the JFTC criteria. [redacted] 25X1

Less Developed Countries

North Yemeni Request for Assistance

North Yemen's President Salih last week urged Saudi King Fahd to provide help for the country's faltering economy. Sanaa's foreign exchange holdings have dropped from $1.6 billion in March 1980 to less than $600 million, [redacted] Last month Salih reportedly held back funding for various government departments, but the military and the security services were not included. [redacted]

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The Saudis, because of reduced oil revenues probably will not give North Yemen much additional aid and may even try to wring political concessions from Sanaa for maintaining official aid at the level of about $300 million it has averaged in recent years. Riyadh has repeatedly urged Salih to cut back Soviet military aid programs for North Yemen. If increased Saudi aid is not forthcoming, Salih will have to institute new austerity measures that could provoke unrest. [redacted] 25X1

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Economic Cabinet Changes in Chile

President Pinochet's cabinet shuffle this week has raised doubts about the government's ability to revive the economy and to resume external debt payments. According to the US Embassy, the new financial team of Finance Minister Caceress and Economy Minister Martin lacks the stature to resolve Chile's financial problems. In announcing the shakeup, Pinochet attacked domestic critics and said there would be no major changes in economic policies.

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The changes will do little to restore confidence, and foreign bankers probably will be more cautious in supporting Santiago's requests to restore credits and renegotiate maturing debt. Caceress and Martin will have to resolve the issue of government guarantees for private-sector foreign borrowings to get the stalled debt renegotiations back on track. Until this problem is resolved, bankers probably will resist new lending. This will hinder financing of necessary imports and could lead to additional domestic bankruptcies.

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Thai Petrochemical Project

Bangkok is moving ahead with an ambitious $870 million petrochemicals complex scheduled for completion by 1990. The project is a key element in Thailand's proposed Eastern Seaboard Development Plan, which is designed to turn a segment of the coast along the Gulf of Thailand into an industrial alternative to overbuilt Bangkok. Despite the present depressed world petrochemicals market, Thai officials argue that the complex is feasible because it will use relatively inexpensive domestic natural gas and because it will sell its output domestically. Bangkok has promised investors protection against competing imports if world prices fall. The supply of natural gas to the project may be a problem, however. Production from Erawan, Thailand's only operating field, is running at about half the projected 7 million cubic meters per day, and Bangkok is counting on the trouble-free development of additional gasfields by 1987 to supply the complex.

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Communist

Soviet Retail Price Increases

The US Embassy in Moscow confirms retail prices of a variety of consumer goods and services have been raised substantially. Although the range and extent of the price increases are not yet known, prices of basic food products reportedly were not changed. The price increases will pass on to the consumer some of the higher costs resulting from 1982 wholesale price increases as well as absorb some of the excess purchasing power of consumers. General Secretary Andropov in late January strongly hinted price hikes were imminent when he told factory workers in Moscow that "incongruities" in certain existing prices must be eliminated. Unlike the past, there has been no public announcement of these price hikes.

Recommendations to raise consumer prices were being publicly voiced even before Brezhnev's death. In fact, recently released Soviet statistics for 1982 imply an inflation rate last year in the USSR of about 3 percent in retail trade. Although Western measures of Soviet price changes have always indicated a moderate rate of inflation in the USSR, official Soviet statistics have consistently recorded almost no inflation. 25X1

Canada: Protectionist Trends [1] [redacted]

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Ottawa is responding to heavy pressure to protect domestic industry by imposing a broad variety of nontariff barriers. Declining domestic demand, coupled with rising import penetration in the automobile, textile, and footwear industries, have caused major cutbacks in Canadian production and have led to restraints on imports of these goods. Canada's protectionist policies are unlikely to decrease no matter which of the two major parties is in office. [redacted]

Government Attitude Toward Protectionism

Canadian business and government leaders have long recognized the need for exports because the domestic market of 24 million people is too small to support large-scale production in many industries. At the same time, successive Canadian governments—while paying lipservice to an open international trading system—have maintained high import tariff walls. In response, foreign—largely US—firms moved inside the walls by investing in Canadian corporations or establishing subsidiaries. Now, foreign firms (74 percent of them US) control 46 percent of Canada's manufacturing sector. The highest degree of foreign ownership is in the electrical products, transportation, and chemical industries, more than three-fourths of which are foreign controlled. [redacted]

To bolster Canadian-owned business, Ottawa has developed a range of instruments to protect Canadian firms. The most extreme example, the National Energy Program, is explicitly aimed at boosting Canadian ownership in the petroleum sector to at least 50 percent. Introduced in 1980 the NEP replaced depletion allowances for oil and gas companies with discriminatory exploration grants.

[1] This article is the first in a series on protectionist trends.

Grant levels are determined by the degree of domestic ownership and control of the exploring company or consortium. Moreover, petroleum companies involved in large energy projects are strongly encouraged to use Canadian sources of supplies and services. [redacted] 25X1

Over the years nontariff barriers have played an increasingly important role in Canadian protectionism. In line with MTN agreements, Ottawa has cut tariffs significantly and further cuts will continue until 1987. [redacted] 25X1

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Canadian agriculture has been a major beneficiary of nontariff protection. Imports of several agricultural commodities, such as fruits and sugar, are subject to quotas. In addition, Canadian farmers benefit from healthy subsidies which boost production and thus discourage imports. Artificially low grain shipping charges have held down the cost of western grain shipped to the eastern provinces. This effectively insulates the market from foreign competition and improves export competitiveness. [redacted]

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Nontariff barriers also play a key role in the manufacturing industry. Traditional measures such as quotas and subsidies are used mainly to protect declining labor intensive industries from low-cost Third World competition. Less visible devices, such as taxes and crown corporations, typically give growth industries—particularly those employing high technology—an advantage in the domstic market.[2] [redacted] 25X1

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[2] Crown corporations are federally or provincially owned corporations. They often invest in growth industries to ensure Canadian participation. For example, the Canadian Development Corporation has invested heavily in the petrochemical industry to develop Canada's natural advantage in that sector. [redacted] 25X1

Canadian Trade Barriers

Tariffs. *Traditionally high; designed to protect small domestic manufacturers from foreign competition. Tariff protection remains significant for the textile, clothing, footwear, shipbuilding, and railcar industries.*

Quotas. *A 1971 law allows Ottawa to impose mandatory restrictions on imports of any manufactures that cause or threaten to cause serious injury to Canadian producers. Canadian quotas are largely directed toward textile and footwear products supplied by Third World manufacturers.*

Taxes. *A 1975 law terminated the tax deductions for expenditures by Canadians on advertising in Canada through the US media. The tax system also encourages Canadians to keep their savings in Canada.*

Government Procurement. *Ottawa and all the provinces have guidelines on government and crown corporation procurement. A price preference of 10 to 15 percent if often granted the domestic producer. Tenders often are not made public and only companies on government lists are allowed to bid. When enough Canadian companies are listed, foreign firms may be barred from bidding.* 25X1

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Subsidies. *Both the Ministry of Industry, Trade, and Commerce and the Department of Regional Economic Expansion offer subsidies to private corporations to encourage domestic production. Common methods employed are loan guarantees and grants. Ottawa has financed a five-year $200 million aid program to restructure the textile and clothing industries.* 25X1

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Crown Corporations. *Petro-Canada, the Canada Development Corporation, Air Canada, and Canadian Rail have invested in key industries thereby increasing Canadian ownership. These corporations often are used to promote development of high-growth industries, for example, petroleum, medical supplies, electric products, and chemicals.* 25X1

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Canadian providers of services also benefit from several protectionist measures. The tax system penalizes firms that patronize publications and broadcasters deemed to have insufficient Canadian ownership. For example, the cost of advertising in newspapers and magazines that have less than 75 percent Canadian ownership cannot be deducted from taxable income. In addition, Ottawa limits foreign participation in the banking industry to 8 percent of the domestic market and mandates that data processing by banks be performed within the country.

Ottawa also has several programs to promote exports—on which nearly one-fourth of the jobs in Canada depends. The Trudeau government has been particularly concerned with stimulating exports of manufactured goods to move away from Canada's traditional reliance on sales of natural resources. The Export Development Corporation (EDC), established in 1968, provides export financing to foreign buyers of Canadian capital goods, equipment and services. In 1981, the EDC provided $1.4 billion in export financing and an additional $2.2 billion in insurance and related guarantees. Last summer, legislation was proposed in Parliament that would double the EDC's authorized $810 million capital to boost its lending power. 25X1

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In the agricultural area the Canadian Wheat Board guarantees export credits at or below commercial rates to purchasers of Canadian grain. Subsidized credit sales by the CWB to the USSR, Poland, and East Germany boosted Canadian grain exports in

1981 and 1982. A bill to set up a government marketing corporation, Canagrex, to promote exports of nongrain agricultural products is now before Parliament.

Recent Trends

Recent economic problems have encouraged the rise of import protection and export promotion policies. Since mid-1981 the Canadian economy has contracted more sharply than in any other postwar period; real GNP plunged 5 percent last year. Since June 1981 the unemployment rate has risen from 7.4 percent to 12.8 percent. Despite a record trade surplus in 1982, the sharp rise in unemployment and severe import penetration in key industries have intensified calls for protection.

Ottawa has taken direct action to curb imports in the automotive, textile and footwear areas. Despite a Voluntary Export Restraint (VER) agreement limiting Japanese sales of automobiles, Japan's share of Canada's automobile market rose from 15 percent in 1980 to 23 percent in 1981, prompting Ottawa to request negotiations for a second VER in 1982. When Tokyo balked at Ottawa's proposal to limit shipments to 146,000 vehicles, Canadian customs authorities began to examine individually all Japanese vehicles entering Vancouver, significantly slowing imports. Japan then agreed to further restraints. Nevertheless, because of slumping Canadian auto production, Japan's share of the automobile market increased even further in 1982. This has pressured Ottawa to tighten restraints; negotiations on a third VER are in progress.

In August 1982, Ottawa reinstated a global quota on leather footwear similar to an existing quota on canvas footwear. In 1978-81 the original quota had contributed to cutting the import share of the leather footwear market from 64 to 52 percent. When the restrictions were suspended in late 1981, leather footwear imports surged 19 percent over the next nine months, dropping domestic production by 15 percent and causing layoffs in many Canadian shoe factories. Although the quota is aimed at low-cost Third World imports, both the United States and the European Community have been affected and have initiated requests for compensation. 25X1 25X1

The situation in the textile industry is similar to that in footwear. Last July, the Canadian textile and apparel industries made a joint submission to Ottawa asking for rollbacks to 1980 levels in textile imports from Hong Kong, South Korea, Taiwan, and China. The request stemmed from the loss of over 27,000 jobs—15 percent of the industries' combined labor force—since May 1981. Negotiations have been inconclusive, and imports of clothing continue to increase. Ottawa is now considering unilateral action to limit textile imports, despite Chinese threats of retaliation against Canadian exports. 25X1 25X1

Continued Protectionist Pressure

The economic outlook remains bleak with only a weak recovery expected over the next two years. Unemployment will remain over 12 percent in 1983 and improve little in 1984. Canadian resource-based exports should pick up as the United States emerges from the recession, but the manufacturing industries—especially machinery, electrical products, and fabricated metals—will be slow to recover. 25X1

Strong and militant labor unions in the automotive and steel industries will continue to press for additional protection. Canadian-US automotive trade presently enjoys duty-free status under the 1965 Auto Pact, but Ottawa is concerned by its growing deficit with the United States in automotive parts trade and has put out feelers on renegotiating the pact. A government-industry study on the status of the Canadian automotive industry will be issued later this year and is likely to suggest that some new protectionist measures are necessary, particularly against Japan. 25X1 25X1

Current US-Canadian Trade Disputes

Canada's Foreign Investment Review Act (FIRA). *Enacted in 1974, FIRA has required some companies investing in Canada to increase their exports from Canada or to favor Canadian suppliers. The United States is challenging FIRA under the GATT, claiming a violation of international agreements on national treatment. The case will establish a precedent in the treatment of national investment policies.*

Bombardier Export Credits. *In July 1982 the EDC offered $560 million in financing to the Manhattan Transit Authority for the purchase of subway cars from Bombardier Inc. of Canada. The financing would cover 85 percent of the contract price, repayable in 10.5 years at an effective interest rate of 9.8 percent. A US competitor complained that the offer violated the prohibition on export subsidies on non-primary goods in Article 9 of the GATT. In addition, the 9.8-percent interest rate was below the OECD consensus rate (11.25 percent at the time) and the repayment period exceeded the maximum OECD terms of 8.5 years. Though the Department of Commerce found in favor of the US complaint, the company has withdrawn its petition and the case has been dropped.* 25X1

Softwood Lumber. *The International Trade Commission has issued a preliminary finding that Canadian subsidies to its timber industry are hurting American lumber producers. US producers have argued that the low fees charged to private Canadian companies to cut timber on public lands constitute a subsidy on the nearly $2 billion in lumber exports to the United States.* 25X1

Regional disparities, aggravated by the current downturn, play a key role in fomenting Canadian protectionism. Although the west's petroleum-based economy has slowed, the traditional manufacturing sector in Quebec and the fishing and lumber industries of the Atlantic provinces have been battered. Spokesmen for Quebec—a stronghold of Trudeau's Liberal Party—have a large impact on his decisions and are pressing for policies to boost economic growth in the east. The push for regional balance will continue as recovery develops faster in the more resource-oriented industries of western Canada.

Party Attitudes. Canada's protectionist policies are unlikely to change greatly after the election to be held by early 1985, although differences do exist between the parties. The Progressive Conservatives under Joe Clark or a new leader are not politically dependent on Quebec but probably cannot afford to ignore further protection of declining, labor-intensive industries. They have supported the Trudeau's government's moves to limit imports over the past two years. The Liberals are unlikely to alter their protectionist policies even if Trudeau retires. 25X1

Protectionism could get a boost, however, if a minority Liberal government takes office, dependent on support from the New Democrats. The New Democrats are highly nationalistic and protectionist, particularly toward unionized heavy industries. Their influence would, at the least, make a minority Liberal government even more sensitive to the fortunes of such industries as automobiles and steel. 25X1 25X1

Implications for the United States

Canadian protectionism has its heaviest impact on the United States because it is Canada's largest trading partner by far. Many of Canada's protectionist measures affect US goods even when they are aimed primarily at low-cost Third World imports. Of particularly serious consequence to the United States are nontariff barriers applied to high technology goods and other manufactures. Nationalist investment policies, tax incentives, and subsi-

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Canadian-US Trade

	1979	1980	1981
Canadian exports			
To the United States (*billion US $*)	38.0	41.2	46.2
As a percent of total exports	68	63	66
As a percent of total US imports	18	17	18
Canadian imports			
From the United States (*billion US $*)	38.8	41.5	45.3
As a percent of total imports	72	71	69
As a percent of total US exports	21	19	18

[redacted] 25X1

dies to manufacturing industries make US goods less competitive in the Canadian market. Canadian electrical products and machinery, for example, are heavily subsidized. Moreover, the items most often benefiting from export promotion—capital goods and wheat—compete directly with US products.

[redacted] 25X1

Government procurement policies are becoming a more prevalent protectionist tool. Many of the goods purchased by Ottawa, the provincial governments, and the crown corporations come from the United States. An early 1982 report estimated that government procurement agencies would spend over $1.5 billion on imports in 1982. All of these entities have now implemented "buy Canadian" policies that could significantly reduce US sales. Regulations mandating increased use of locally provided materials in large public and private energy projects, for example, will have a substantial impact on US suppliers of oil and gas equipment. [redacted] 25X1

[redacted] 25X1

International Finance: The IMF Quota Issue

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If, as now envisaged, demands on IMF resources from troubled borrowers continue to mount, the IMF could run out of funds this year. As of yearend 1982, the Fund had some $30 billion for new lending, but it has committed or is about to commit almost $25 billion through programs with Mexico, Brazil, Argentina, and other countries, leaving a scant $5 billion to handle new requests. The IMF may choose not to maintain such ambitious programs by borrowing new funds. In any event it would quickly run into statutory limits on its own borrowing, which cannot exceed 60 percent of the level of quotas.

Quotas, or members' subscriptions, account for about two-thirds of the IMF's resources; the remainder is borrowed. Quotas, which also represent the members' voting strength in the organization, are reviewed at least once every five years and revised if necessary. Under the eighth quota review, the IMF last week agreed to boost members' subscriptions from about $65 billion to approximately $100 billiön on the assumption that increased resources will be necessary to meet members' needs for balance-of-payments assistance through most of the 1980s. If approved by member governments, these additional resources probably would become available to the IMF beginning in late 1983 or in 1984. The US quota is about 20 percent of the total.

Demands on the IMF

The IMF plays a vital role in assisting countries suffering from temporary balance-of-payments problems. After the first oil shock, it was able to meet the needs of as many as 60 countries because the average needs of each country were relatively small, as drawings over $1 billion were made only by Italy in 1974 and 1975 and by the United Kingdom in 1976 and 1977. In addition, special facilities financed outside the quota system met a large share of the borrowing needs.

Pressures to borrow from the IMF are now more severe because of the wrenching structural adjustments to global recession that nearly every country is experiencing. In 1982, 64 countries drew a record $9.7 billion from the Fund, with the pace of borrowing accelerating sharply in the fourth quarter. Drawings in 1983 will be even greater as the Fund makes disbursements to borrowers—notably Brazil, Mexico, and Argentina, who were negotiating IMF programs at yearend.

Moreover, we do not expect demands on the IMF to abate for several years. Widely publicized, multi-billion dollar emergency credits for such countries as Mexico, Brazil, and Argentina are only short-term measures to meet immediate cash crises and prevent default. It is the accompanying programs of financial conservatism that address the underlying problems. However, it will take perhaps three to four years of sustained effort for major borrowers to restore their creditworthiness, regain normal access to financial markets, and resume robust economic growth.

The Impact of Global Recession

The persistent and worsening financial situation of the LDCs is closely tied to the global recession that is now well into its third year. In particular, LDC exporters have been hit by a collapse of commodity prices without any rise in industrial country demand. Eight of the 12 Third World countries with

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Member Borrowings from the IMF *Million US $*

Year	Number of Countries	Total	Average	Year	Number of Countries	Total	Average
1970	41	1,510	37	1977	36	4,010	111
1971	34	1,900	56	1978	33	4,680	142
1972	27	1,760	65	1979	42	2,380	57
1973	25	870	35	1980	49	4,880	100
1974	50	4,860	97	1981	59	8,270	140
1975	54	5,640	104	1982	64	9,660	151
1976	60	8,060	134				

the most serious debt problems suffered major declines in export earnings last year, while the others experienced sharp drops in the growth of export earnings. In addition, the rise in interest rates that took place over 1980 and 1981 added some $10 billion in debt service costs to LDCs during that period. The burden of interest payments rose to over one-fourth of the total foreign earnings for such countries as Mexico, Brazil, Chile, and Argentina.

Any acceleration in the OECD's economic recovery would provide the LDCs with needed breathing room, in part because it would signal the banking community that LDC export prospects will improve, putting the LDCs in a better position to handle their debts. However, the direct gains from a more rapid OECD expansion will not be felt immediately and will not be evenly distributed among the troubled debtors. In our judgment, most of the initial pickup in economic activity will be concentrated in the consumer sector. Increased demand for LDC raw materials will take considerably longer to materialize in part because of the large inventory overhang for many raw materials.

Further Shocks Likely

While this OECD-growth-led recovery is taking place, the IMF may have to handle additional shocks brought on by the adjustment process itself. An unprecedented number of countries with complex international linkages will all be attempting to reform their economies over the same period. Taken individually, the prospects that each country could smoothly adjust under the aegis of the IMF are good; together, adjustment raises new problems. In 1981, for example, Brazil and Argentina each sold about 20 percent of their exports to other South American countries and purchased about 15 percent of their imports from them. Bolivia, Paraguay, and Uruguay probably will find it increasingly difficult to meet debt payments and import bills because of their heavy dependence on sales to troubled neighbors.

Moreover, IMF help might be needed to handle any shocks that may arise from an uncertain oil market over the next several years. Mexico, for example, could lose over $5 billion in foreign

earnings if oil prices fall to $20 per barrel. Without compensating financing, Mexico would have to cut imports by that amount on top of the 40-percent reduction, to $15 billion, that occurred last year. Nigeria, Venezuela, and Indonesia will be running into increasingly serious financial constraints this year even if oil prices remain steady. If prices decline to $20 per barrel, these countries would have a combined drop in earnings of $17 billion. We do not believe that foreign bankers would be willing to increase exposure in these countries much, if at all. None of these countries has much maneuvering room; all have been drawing down their reserves substantially in recent months to pay for needed imports and debt servicing.

The adjustments demanded by the IMF and private creditors have high political and economic costs, which are in part held in check by the assurance of continued IMF support if needed and by the opportunity for national governments to share the onus of adjustment with a faceless but respected partner. In the absence of such discipline, we believe that political pressure could force governments to abandon adjustment programs, thereby sacrificing the longer term development of their countries. The prospects for this are probably highest in such countries as Argentina and Mexico with highly nationalist governments.

The Demonstration Effect of IMF Participation

Even though a quota increase would probably not show up on the IMF's books until late 1983 or in 1984, its approval would boost the sagging confidence of commercial lenders that the Fund will continue to back adjustment programs that will help debtors to meet their obligations. For the next few months, major US and other industrial country banks may again be called on to provide a quick infusion of cash to these borrowers to avert a crisis. Emergency loans by large banks, however, will only provide a temporary solution to South American debt problems. If the smaller institutions continue to reduce their lending, debt service could become unmanageable without full IMF participation.

New Lending Associated with IMF Programs *Billion US $*

Country	Estimated Debt Yearend 1982	IMF Package	New Lending Associated With IMF Package
Argentina	40	2.2	1.5
Brazil	87	5.5	4.4
Mexico	83	3.9	5.0
Yugoslavia	19	0.5 [a]	1.0

[a] Third year of the 1981-83 standby arrangement.

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Beyond this, IMF programs—which include plans for restructuring financially troubled economies and monitoring their progress—are the key to convincing foreign private banks to share the cost of the economic adjustments the LDCs must make. The IMF programs recently under negotiation are associated with a substantial amount of new bank lending. The Fund's involvement and leverage over debtor countries have been crucial to getting commercial banks to continue to provide credit when it is needed most to ease the adjustment process.

A growing number of other Latin American countries are increasingly vulnerable to a credit contraction that could be precipitated by a lack of confidence that the IMF will continue to lead in solving debtors' cash problems:

- Chile's financial position, already weakened by a decline in exports, capital flight, and a slowdown in new lending, turned critical after bankers stopped credit operations in a recent financial dispute with the government.

- Venezuela is increasingly vulnerable to a loss of banker confidence because of its poor economic and financial management, high short-term debt, dwindling reserves, and uncertain oil export prospects. International lenders are shying away from new loans, undermining the government's plans to refinance short-term public debt. Failure to refinance these could lead to debt rescheduling.

- Argentina is vulnerable to another credit contraction because of its need to arrange new financing to roll over maturing debt. Smaller US banks may be especially unwilling to renew lending necessary to finance exports and purchase needed imported industrial supplies.

- Peru is also encountering difficulty in obtaining longer term credits, despite its willingness to pay higher rates.

The European View

West European leaders were generally in favor of greater increases in the IMF's lending capability than the United States. Initially some major European countries were sympathetic to increases of about 65 percent. The European negotiating position last week was for a 50-percent increase, or 10 percentage points higher than the United States' initial position. West Europeans subscribe to the idea that IMF resources must be augmented to improve the debt service capability of troubled borrowers in the absence so far of a strong economic recovery in the West. They further believe that the IMF is the key organization to convince debtors to make necessary financial adjustments, and that the IMF is in a strong position to persuade private banks to maintain their exposure.

The West European governments probably believe that the 47.5-percent quota increase that emerged was the best possible under current economic conditions and the political mood in the United States. West Europeans believe the quota increase will be adequate for only about three years and that the five-year review process will need to be replaced by another three-year review. The West Europeans view the immediate need for liquidity as great, and they fear that the end-of-year deadline for implementing the quota increase is not soon enough; nonetheless, they strongly oppose IMF borrowing in the private markets to fill the gap.

The European reaction to a failure on the part of the US Congress to ratify the US share of the quota increase probably would be dramatic. Any backing away by the United States to support the quota increase would be viewed by West European governments as a reversal of the present policy of working together for a coordinated response to international financial problems. West European bankers probably would echo this criticism and tighten credit across the board in self defense.

We have not seen any evidence so far that European capitals consider the increase in the US quota in doubt. They probably foresee a contentious Congress but calculate that the Congress will eventually view approval in the United States' best interest.

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Coal Synfuels: Diminished Expectations

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Declining oil prices, escalating capital costs, and reduced government funding have caused massive cancellations and delays in coal-synfuel projects around the world. These cutbacks and a recent study by the Institute of Gas Technology suggest to us that Free World production of synthetic fuels from coal will increase by less than 1 million barrels per day oil equivalent (b/doe) by the year 2000—approximately one-third the growth forecast by the International Energy Agency (IEA) in 1981. As a result, coal synfuels are unlikely to contribute much toward reducing the Free World's dependence on Middle East oil or Western Europe's and Japan's rising reliance on imported natural gas over the next two decades.

Changing Outlook

Following the 1973 oil crisis, many observers believed production of synthetic fuels from coal would grow rapidly. Coal-synfuels technology had a long history of development, and world coal reserves were twice those of oil and natural gas; nearly 50 percent of proved recoverable reserves are in the United States, Australia, and Canada. With oil prices expected to continue rising, most analysts believed coal synfuels would be cost competitive by the mid-1980s. According to 1976 industry assessments, synthetic natural gas from coal was expected to cost about $19 per boe and coal-based syncrude about $25 per boe.

The 1979 oil crisis gave added impetus to coal synfuels. Spurred by the cutoff of Iranian oil, the South African Government initiated a crash program to expand its synfuels industry through construction of a third, large-scale coal conversion plant (SASOL III). In other countries, research and development on coal-synfuels technology surged; IEA member government expenditures on coal synfuels R&D and demonstration plants jumped from about $400 million in 1978 to over $700 million by 1981 25X1

During the last two years, numerous coal-based synfuel projects have been delayed or abandoned. Coal liquefaction efforts have been especially hard hit. Plans for the construction of the first commercial-scale direct liquefaction facility (SRC-II)—a joint venture between the United States, West Germany, and Japan—were canceled in mid-1981. In Australia—once the center for technology development—liquefaction projects have been almost completely cut back, according to industry officials. As for coal gasification, although some small, commercial-scale projects are proceeding, plans for large-scale plants have, for the most part, been scrapped. Three projects in the United States, for example, with a combined output of over 150,000 b/doe have been canceled over the past 18 months. In Western Europe, Shell has backed out of two projects—the largest with an output of 40,000 b/doe—and Gasunie, the Dutch gas monopoly, has shelved plans for a 20,000 b/doe plant. 25X1

Cutbacks stem largely from:
- Weak oil prices; most industry forecasts now assume flat or declining real oil prices to 1985, with prices rising by only 2 to 3 percent per year thereafter.
- Sharply rising capital requirements; the estimated cost of the Dutch gasification plant, for example, more than tripled in just three years.
- Reduced government funding because of burgeoning budget deficits and lower than expected growth in energy demand.

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Types of Coal Synfuels

From Gasification

- *Low-BTU gas (about 5,300-8,800 BTU per cubic meter), used for combined cycle power systems.*
- *Medium-BTU gas (about 12,400 BTU per cubic meter), which can be transported short distances and used as a chemical feedstock, fuel gas, reducing gas for metallurgical purposes, and as an input to liquid hydrocarbon production.*
- *High-BTU gas (about 35,300 BTU per cubic meter, the same as natural gas) for use as pipeline-quality fuel.*

From Liquefaction

- *Synthesis gas, methanol, and synthetic petroleum liquids, such as fuel oil, gasoline, diesel fuel, and kerosene.* [redacted] 25X1

- Availability of cheaper alternatives to coal synfuels such as Soviet natural gas. [redacted] 25X1

Technology

Present synfuels production is based on coal conversion processes developed in the 1920s and 1930s. The processes are largely inefficient; from 40 to 60 percent of coal's energy content is lost, with the higher losses applying to the production of premium fuels. Consequently, much of the benefit in low-cost coal is lost in processing. [redacted] 25X1

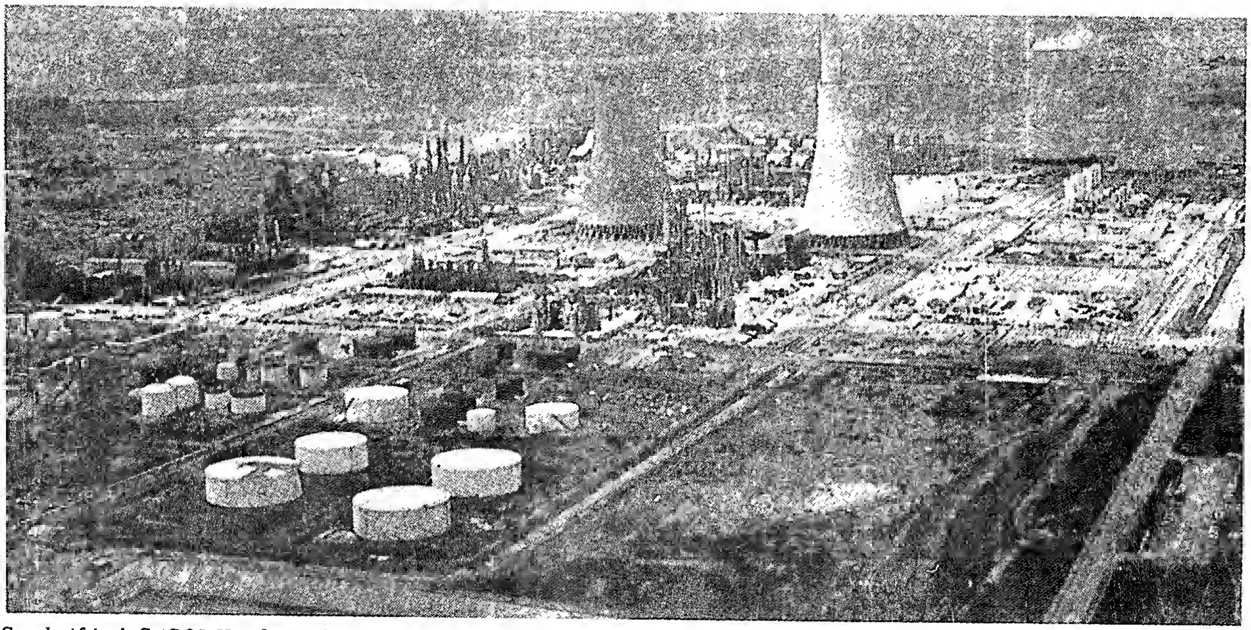
Gasification and liquefaction processes under development represent an extension of existing technology in a quest for greater efficiency, adaptability to a broader range of coal types and production of higher value products. According to a recent assessment of coal conversion technologies by the Institute of Gas Technology (IGT), however, most of the approximately 40 coal conversion processes under development outside the United States will not progress beyond the demonstration phase because of technical, economic, or marketing problems. All gasification and liquefaction processes, moreover, must undergo substantial development before large-scale plants can be built. According to the IGT study:

- Improved coal gasification techniques will not be ready for large-scale implementation until the late 1980s.
- Direct liquefaction processes will not be ready for commercial use until the early 1990s. [redacted] 25X1

Coal Gasification. Low- and medium-BTU gas has been produced from coal for more than 100 years, and many plants are currently in operation. First-generation technology to produce high-BTU gas is proven and commercially available but is relatively expensive and inefficient. A commercial-scale plant (20,000 b/doe and up) based on more efficient second-generation processes and able to use a wider variety of coals has not yet been attempted. [redacted] 25X1

Coal Liquefaction. Technology for liquefaction has not progressed as far as that for gasification and appears even less economically attractive. The only commercially available process—used in South Africa's SASOL plants—produces medium-BTU gas from coal and then chemically combines the gas to form liquid products such as heating oil and gasoline. This two-stage process, however, is extremely inefficient, using up more than half of the coal's energy content in the conversion process. Most analysts contend that the process is used in South Africa only because of large coal reserves, low mining costs, and Pretoria's willingness to subsidize the process to lessen South Africa's vulnerability to an oil embargo. [redacted] 25X1

Second-generation liquefaction processes avoid the gasification step and liquefy the coal directly. Although several pilot plants have been constructed, none of the individual processes has been proven in sustained, large-scale operation, and numerous



South Africa's SASOL II—the world's largest coal conversion plant—completed at a cost of nearly $3 billion.

uncertainties remain. All of the processes, for example, must preheat a slurry of pulverized coal and oil before the liquefaction process takes place, a step that remains difficult at sustained high operating rates with varying types of coal. Moreover, with the cancellation of the SRC-II project in 1981, large liquefaction plants will now have to be scaled up from around 500 b/d rather than from the proposed 15,000 b/d capacity of the SRC-II plant. Cancellation of this project could set back commercialization of liquefaction technology by 10 years, according to press reports. [redacted]

Synfuel Economics

Production costs for coal synfuels—both gas and liquid—have risen sharply since 1973, outpacing oil and gas price increases. Escalating capital costs have been the key factor. Synfuels processes are highly capital intensive, and capital charges account for about two-thirds of the product price of synthetic liquids. [redacted] capital requirements were severely underestimated in the mid-1970s because of limited engineering and technical information. Since then costs have been further boosted by inflation, record-high interest rates, and environmental regulations. [redacted] 25X1

Based on current technology and recent detailed capital cost assessments by industry and government sources, the future cost of coal synfuels from full-size plants probably will range between $60 and $100 per boe for liquids and between $35 and $65 per boe for synthetic natural gas. Because of the extensive work on coal synfuels, we believe it is 25X1 unlikely that there will be major breakthroughs that will significantly reduce present cost assessments or render current technology obsolete. [redacted] 25X1

Because of higher estimated production costs for liquid synfuels, price competitiveness with oil has been postponed by 15 years or more. With current oil prices of $34 per barrel, we believe synthetic petroleum products from coal probably will not be economic until around the year 2000, even if real

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oil prices increase 3 percent per year. Even then, capital needs for a commercial-scale liquefaction plant of $3 billion or more may hinder construction. [redacted]

Coal gasification is less costly than liquids production. Given current natural gas prices of about $27 per boe in Western Europe and $32 per boe in Japan, industry analysts believe synthetic natural gas may become cost competitive in the 1990s if gas prices rise in tandem with oil prices. Once again, however, huge capital requirements are a major constraint. Some industry analysts contend, for example, that it would cost $54 billion to construct the necessary coal gasification plants to equal the energy throughput of the Soviet gas pipeline. In contrast, West European construction and equipment loans for the pipeline now total about $8 billion. [redacted]

Synfuel Backers

South Africa. Determined to lessen its vulnerability to an oil cutoff, Pretoria is the world's leader in commercial-scale coal conversion. When the country's three SASOL plants are operating at capacity in 1985, they are scheduled to provide about 115,000 b/d of product and supply roughly half of South Africa's liquid fuel needs. Plans for the construction of a fourth plant (SASOL IV) are in the study phase. According to recent State Department reporting, South Africa must add a new synfuels plant the size of SASOL II or III every four or five years to maintain the percentage of its energy requirements produced from local sources. [redacted]

West Germany. Building on established World War II technology and backed by government funding, West Germany is the world's leader in coal synfuels technology. Despite recent project cutbacks, the government remains committed to developing this technology, primarily for export. According to State Department reporting, two gasification projects and a liquefaction project probably will continue to receive partial (40-50 percent) government support. Under the government's proposed budget for energy R&D, coal synfuels have been allocated $900 million for the period 1982-85. [redacted]

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Japan. Dependent upon imported oil for over 60 percent of its energy requirements, Japan remains active in developing coal synfuels. Three liquefaction processes now under separate development are to be combined into one process through the construction of a 750-1,500 b/doe pilot plant. Construction of a 150 b/doe liquefaction pilot plant in Australia is also proceeding under a Japanese-Australian joint venture agreement. [redacted] Tokyo no longer expects to meet the goals set in 1979 for its alternative energy research program. While the program envisioned an annual synfuels output of nearly 600,000 b/doe in 1995, the IGT forecast places production at only 30,000 b/doe in 1995 and 50,000 b/doe in 2000. [redacted]

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Outlook

Free World production of coal-based synthetic fuels is approximately 300,000 b/doe, less than 1 percent of oil output. Based on the IGT assessment, we estimate production will increase by less than 1 million b/doe by the end of the century—approximately one-third the growth forecast by the International Energy Agency in 1981. Because of huge capital costs, construction of large-scale synfuels plants will be rare. Relatively small facilities, each producing about 12,000 b/doe or less, will be used to meet localized supply needs and to prove selected technologies. South Africa, we believe, will continue as the major synfuel producer because of a desire to reduce dependence on imported oil. [redacted]

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Because of the cancellation of many commercial-scale and demonstration plants, coal synfuels will provide little cushion in the event of an oil supply disruption. Facilities require up to six years for construction, and we believe the industry will lose critical technical and engineering skills as projects are canceled or postponed indefinitely. [redacted]

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